WRCIC
WESTERN REGION CAPTIVE INSURANCE CONFERENCE, LLC

Viva la captives!

2022 ANNUAL CONFERENCE • JUNE 27-29, 2022 • THE COSMOPOLITAN OF LAS VEGAS • LAS VEGAS, NV

Captive Taxation: Nothing is Constant But Change

Panelists:

P. Bruce Wright, Senior Counsel, Eversheds Sutherland (LLP) US
Charles Lavelle, Partner, Dentons Bingham & Greenebaum LLP
Bailey Roese, Partner, Dentons Bingham & Greenebaum LLP
Joseph Holahan, Partner, Morris, Manning & Martin, LLP

June 28, 2022

1

AGENDA

- 2022 Section 831(b) Developments
- State Income Taxes
- Delaware D&O
- Employee Benefits
- Washington State

2

SECTION 831(b) - BACKGROUND

- Enormous IRS audit and litigation activity has been with small captives
  - Transaction of Interest, 8886 filings
  - IRS seeks to audit all captives electing section 831(b)
  - 12 Audit Teams, "promotor" investigations, criminal, fraud and other units
  - IRS seeking 200 experienced "tax shelter" lawyers
  - Commissioner Rettig: IRS asserting 75% civil tax fraud penalty
- Small captive cases are defining "insurance" for tax purposes (applies to large captives too)
- Some issues are being raised in the small captive cases (sample)
  - Disallowed premiums can also be taxed to the captive (*Syzygy*)
  - The pooling entity must be an insurance company for tax
  - Courts are skeptical about pools – premiums paid to pool equal premiums paid by pool
  - Must captive insurance replace commercial coverages?
  - May policies be standardized?
- IRS now has large numbers of Insurance Specialists and has developed audit techniques
- Lobbying and Letters from Congress Supporting Captives

3

SECTION 831(b): RECENT DEVELOPMENTS

- President Biden's Budget Proposal would tax certain "831(b)" Captives
  - Have at least one insured (including affiliates) that is more than 20% of the premiums
  - Amount is "distribution" (including loans, dividends, nondeductible affiliated expenses)
  - Distribution amount is "grossed up" by 1 minus increased rate (highest corporate tax rate plus 10%)
    - Limited to accumulated amount computed under section 831(a)
  - Tax rate is highest corporate tax rate plus 10% "penalty" rate (on grossed up adjustment, not tax)
- *CD Listening Bar*: In 2012, the captive participated in same reinsurance pool as the taxpayer in *Avrahami* did in 2009-2010. The IRS argued the taxpayer automatically lost based on the decision in *Avrahami*, but the Court disagreed and dismissed the IRS's motion for summary judgment.
- GAO Report on IRS Audits of Offshore "Micro-captives"

4

SECTION 831(b): RECENT DEVELOPMENTS

- IRS adds Puerto Rican and other foreign captive arrangements to "Dirty Dozen" list
- IRS requests formal comments on Form 8886
  - SIIA's formal comments:
    - Form 8886 is overbroad in scope
    - Duplicative
    - Requires significant financial costs incurred to report
    - Ongoing in nature
    - Creates uncertainty as to how to comply
    - Demonstrates lack of IRS information access and digital capabilities

5

SECTION 831(b): RECENT DEVELOPMENTS

- ***CIC Services, LLC v. IRS***
- Supreme Court held that taxpayer could seek an injunction from IRS obtaining information under Notice 2016-66.
- The Court did NOT make any determinations regarding what is insurance for tax purposes. Instead, it dealt with the Administrative Procedures Act and the Anti-Injunction Act
- On remand, District Court granted a permanent injunction and vacated Notice 2016-66 for all taxpayers.
- District Court judge also initially ordered the IRS to return to taxpayers and material advisers all documents collected under the vacated Notice (Forms 8886 and 8918)
- However, on June 2, the judge reversed course after a motion to reconsider, and held that he did have the authority to take such action.
- The DOJ had argued that unless a taxpayer files a request with the IRS for the return of such documents, a court did not have the authority to command the IRS to provide such relief to nonparties

6

SECTION 831(b): RECENT DEVELOPMENTS

- ***US (IRS) v. Delaware Department of Insurance***
- Court held for the IRS
  - Statute providing for confidentiality of documents was not the "business of insurance" so the IRS had the right to summon material despite McCarren Ferguson state regulation
- Case has been appealed to Third Circuit
  - Delaware also asked for a stay to avoid turning over material until appeal is concluded. IRS opposes the stay.
- Parties have briefed the issue. DDOI has argued that the IRS should obtain information directly from taxpayers/captive managers. IRS has argued that would be overly burdensome, and that the targets/captive industry have incentives not comply
- Industry wrote amicus brief

7

SECTION 831(b): RECENT DEVELOPMENTS

- ***Reserve Mechanical v. IRS***
- Tenth Circuit struck down captive insurance arrangement and held it was not insurance for tax purposes. Pool arrangement.
- Tax Court: Taxpayer had called numerous witnesses, including seven experts, to demonstrate insurance was present.
- Tax Court judge rejected or ignored that testimony and held for government.
- Tenth Circuit largely adopted the Tax Court's findings of fact and was deferential to those findings.
- Industry wrote an amicus brief
- Positive takeaways: Court did not strike down captive arrangements generally. Though the Court held this arrangement was not insurance for tax law purposes, pools can still work.

8

SECTION 831(b): RECENT DEVELOPMENTS

- "The courts have recognized, and the Commissioner concedes, that certain arrangements distributing risk provide insurance even though there is no insurance company involved."
- Facts and circumstances are still the key. What may work in one instance, may not in another, depending on the details.
- While the IRS is on a winning streak in court, that does not mean that every case loses (*see – Puglisi*).
- IRS issued an information release on the case, stating, "U.S. Court of Appeals ruling affirms IRS position that abusive microcaptive insurance transactions are shams"

9

STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

- For complex corporate groups, a state may try to tax a portion of the income of the entire group on the basis of the state's connection to one part of the group (*e.G.*, A subsidiary)
- Traditionally, insurance companies were exempt from corporate income tax considerations because they were subject to a state's premium tax (with a few exceptions), and were required to file separate returns

10

STATE INCOME TAXES – UPDATES AND CONSIDERATION

- Several states have sought to tax the income of a captive insurance company regardless of whether or not it was "doing business" in the state
  - The state adds the captive insurance company's income to the corporate group of which it is part and which is subjct to tax in the state
  - Can cause an administrative and tax burden for corporate groups that are doing business in multiple states
  - Important to review state filing obligations and weigh effect of potential state income taxation

11

STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

- ILLINOIS
  - *Wendy's int'l inc. V. HAMER*, 375 ill. Dec 194 (2013)
- NEW YORK
  - "Overstuffed captive" – taxes income of a captive if gross investment income exceeds gross premium income

12

STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

- Some states focus their tax on "disqualified captives" with rules similar to New York
- MINNESOTA
  - Captive income is included in group income if it is a "disqualified captive", **defined as a captive that receives less than 50% of its gross receipts from premiums,** or pays less than .5% of its total premiums under state insurance premium tax or comparable tax in another state

13

STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

- Some states focus their tax on "disqualified captives" with rules similar to New York
- COLORADO
  - Taxes income of a disqualified captive insurance company, *i.e.*, **A captive that has gross receipts of 50% or less in premiums** (as defined by the internal revenue code)
  - Disqualified captives not subject to premium tax (but note DPT obligations)

14

STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

- OREGON
  - Imposes a corporate activity tax (slightly different than in income tax – imposed on the privilege of "doing business" in Oregon) and kicks in after $1m of commercial activity in Oregon
  - "Commercial activity" means:
    - Total amount realized by a person, arising from transactions and activity in the regular course of the person's trade or business, without deduction for expenses incurred by the trade or business

15

STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

- OREGON
  - "Commercial activity" means:
    - If received by an insurer – as reported on the statemnt of premiums in the annual statement
    - Includes all gross direct premiums and gross surplus lines premiums received on Oregon home state risks
    - Excludes federally reinsured premiums or income between a reciprocal insurer and its attorney-in-fact, compensation, and proceeds received on the account of payments from insurance policies owned by the taxpayer

16

DELAWARE ENACTS LEGISLATION TO PERMIT CAPTIVES TO WRITE D&O INSURANCE

- Generally, most companies purchase D&O coverage which, at a minimum, provides side a coverage for directors and officers which covers, among other things, obligations associated with derivative actions
- In Delaware and many other states, directors and officers sued in derivative actions cannot, by statute, be indemnified by the corporation in whose name the suit is brought

17

DELAWARE ENACTS LEGISLATION TO PERMIT CAPTIVES TO WRITE D&O INSURANCE

- In the past, concern has been raised regarding using a captive for side a coverage to insure, *e.g.*, Derivative suits against directors and officers, because it appears to be indemnification as a result of the corporation paying all of the premiums and capitalizing the captive

18

DELAWARE ENACTS LEGISLATION TO PERMIT CAPTIVES TO WRITE D&O INSURANCE

- Delaware has now passed legislation to allow a captive insurer **in any jurisdiction** to provide D&O insurance for directors and officers of a Delaware entity (including coverage for):
  i. "Personal profit or other financial advantage to which such person is not entitled, or
  ii. A deliberate criminal or deliberate fraudulent act or knowing violation of law
  iii. If established by a final, non-appealable adjudication in the underlying proceeding", [*i.e.,* The captive can pay if the payment is made in a settlement]

19

DELAWARE ENACTS LEGISLATION TO PERMIT CAPTIVES TO WRITE D&O INSURANCE

- But some issues arise
  - What happens if the captive is not in Delaware and local law precludes indemnification in a derivative suit
  - What is insurance
    - Single purpose captive hastily formed
    - Longer term funding with other risks
  - Securities laws suits
  - Direct placement tax issue

20

BENEFITS IN CAPTIVES

- Background
  - Going back to early 1990's, idea to write employee benefits in captives, see Rev. Rul. 92-93 and Rev. Rul. 2014-15
  - The issue, however, was that erisa treated such transactions as prohibited transactions, *e.g.*, A transaction between a **plan** and an entity 100%-owned by the employer, *i.e.*, The captive

21

BENEFITS IN CAPTIVES

- In 2000, DOL issued a PTE in Columbia Energy wherein captive was permitted to reinsure welfare benefits
  - Captive based in bermuda with 953(d) election and branch in Vermont
  - Independent fiduciary
  - Additional benefit to employees
  - Fronting company "a" rated
  - No commissions*
  - Reinsurance indemnity (*i.e.*, Not assumption)
- Over the years, DOL changed necessary benefit to employees

22

BENEFITS IN CAPTIVES

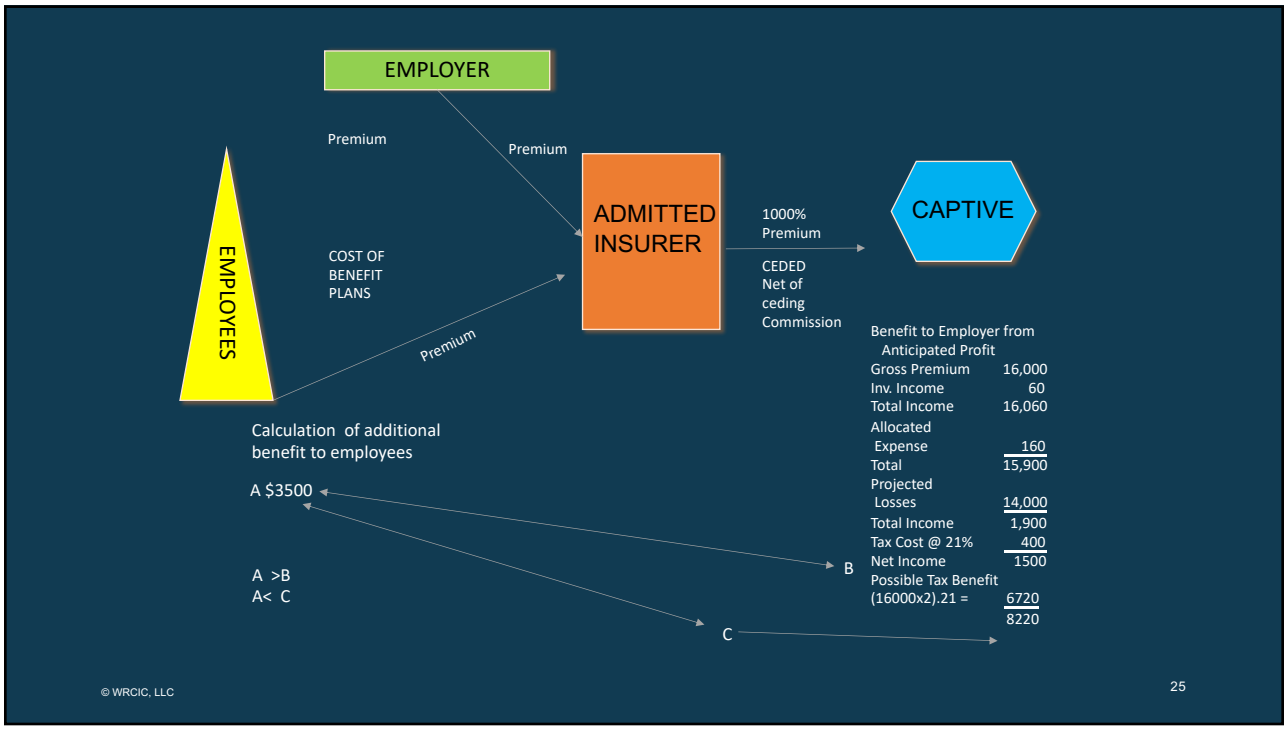
- New rules
  - Beginning in 2018, DOL set forth several new rules for securing an exemption
  - Significant new burdens placed on independent fiduciary
  - Required analysis to demonstrate principal benefits to be provided to employees, *i.e.*, 51% of benefit

23

BENEFITS IN CAPTIVES

- DIAGRAM TO FOLLOW

24



25

Washington State

- Beginning in 2018, Washington Insurance Commissioner brought administrative actions against captives owned by large companies based in state, alleging
  - Doing unauthorized business of insurance
  - Owed premium taxes
- 2020: Study of captive insurance commissioned by OIC and DOR at request of legislature
- Compromise legislation enacted in 2021

26

Washington Captive Regulation and Taxation

- New law applies to "eligible captive insurers"
- Eligible captive insurer
  - Wholly or partially owned by for-profit or nonprofit entity or public institution of higher education
  - Insures risks of captive owner or affiliates or both
  - One or more insureds has principal place of business in Washington
  - Net assets ≥ $1M and can pay debts as they come due as verified by audited financial statement
  - Licensed as captive insurer in domicile
- Regulations do not apply to risk retention groups or captives that solely place insurance through surplus lines broker
- Non-eligible captive insurers are not authorized to do business in Washington, but NRRA home state rule and other federal law may preempt authority of WA to tax or regulate

27

Washington—Eligible Captive Insurer Registration and Tax

- Register with Insurance Commissioner (annual renewal April 1) and obtain approval of registration
- Annually by March 1 pay 2% tax on premiums for insurance directly procured by and provided to parent or other affiliate for Washington risks
  - Washington risks only
  - Reinsurance not subject to tax
  - Look back to 2011 (but no penalties or interest)
  - Captive affiliated with public institution of higher education exempt from tax

28

Washington—Eligible Captive Insurer Restrictions

- May write property and casualty insurance only
- No stop loss for self-funded employee benefit plans
- May insure captive owner and affiliates only
- Preceding restrictions do not apply to reinsurance or surplus lines, but authority to write stop loss on surplus lines basis unclear
- May not provide WC insurance that directly covers workers but may indemnify self-insured employer for WC liability

29

Questions or Comments?

WRCIC
WESTERN REGION CAPTIVE INSURANCE CONFERENCE, LLC

30